THE NEW INCOME TAX

The new income tax law, which is known officially as Section II of the Tariff Act of October 3, 1913, is the result of a movement that has been going on in this country for over a third of a century. The great western democratic upheaval which brought forth the many radical granger laws of the seventies and eighties dominated not only state but also national legislation and forced the enactment of the silver, interstate commerce, and anti-trust acts. It produced, also, as a part of the same general legislation, the income tax law of 1894, a law not premature in the time of its enactment, but, nevertheless, one which was soon nullified by the United States Supreme Court in a decision that the great majority of citizens considered a radical reversal of long standing precedents and an unwarranted overthrow of the will of the people. No decision during the present generation has so shaken the confidence of the masses in the fairness of this high tribunal nor has any brought forth so many assaults upon its integrity. Perhaps even more lamentable was the arousing and increasing of class prejudice throughout the nation.[1]

It was some time before the masses and their leaders recovered from the shock of this decision. The great western movement had been effectually checked and thwarted; the former silver legislation had already been repealed; the great trusts had succeeded in circumventing the anti-trust law; and the gold forces were soon to establish their standard upon a firm foundation. Any effort to secure an income tax seemed hopeless unless the Supreme Court could be reorganized or an amendment to the federal Constitution adopted. The former alternative was impossible so long as the opposing hosts were in political power, and the latter was almost equally hopeless because people had almost come to believe that formal changes in the Constitution were practically impossible short of civil war. The gradual relief from the prolonged economic stress of that period tended to lessen the pressure for an income tax, and before long the attention of the nation was diverted by the Spanish-American War and the great industrial revival and scramble for world markets, which followed that event.

But in spite of these facts, there were several attempts to circumvent the court's decision and to accomplish by indirection

[1] Seligman's *Income Tax* (1911) contains an admirable discussion of this decision and of the succeeding efforts to secure a national income tax.

what had failed through direct means. During the Spanish-American War it was proposed to tax the gross earnings of corporations, but when the bill "emerged from committee, it provided for a special excise tax on the gross receipts of companies refining petroleum and sugar." Obviously, it was meant to appear as a tax upon two of the most unpopular trusts. This bill became law and the Supreme Court held it to be not in conflict with the income tax decision. A federal inheritance tax of the same period was upheld also as not being a direct tax within the meaning of the Constitution.

Various political leaders, including President Roosevelt, expressed not only the desirability of a federal income tax, but also the belief that one could be framed in such a way as to be upheld by the court. After the Democratic party had put in its platform of 1908 a demand for a constitutional amendment, Mr. Taft, as the candidate of the Republican party, expressed the opinion that no constitutional amendment was needed, but that if the protective system should fail to furnish enough revenue an income tax that would be upheld could be devised. But in his inaugural address, he said nothing about an income tax; instead, he suggested an inheritance tax if customs revenues should prove inadequate. A provision for such a tax was introduced into the new tariff bill of 1909, but the opposition by the states to a federal tax on inheritances and the western demand for an income tax were so great that the inheritance tax provision was dropped.

But in order to head off the movement for a general income tax, the Republican leaders were forced to favor a low excise tax upon corporations and to provide for the submission of a constitutional amendment, perhaps with the belief and hope that it would never receive the requisite approval of three fourths of the states. The fate of the amendment was doubtful for some time, particularly after its rejection by New York, Massachusetts, and other influential states. In fact, it did not become law until 1913, that is, not until after the leaders of the new Democratic administration had decided to enact an income tax under the guise of an excise tax if the amendment should fail or if its adoption were delayed longer. But its final ratification just at the time the new administration came in opened the way for a direct income tax, and the new law is the result.

As was to be expected, many criticisms of the bill were made while it was pending. Before it was finally passed several minor

changes were made, but few amendments involved fundamental principles. All classes of interests throughout the country conceded that it would be enacted substantially as introduced and few offered objections to the general principle of income taxation. Many did object, however, to various details, particularly to the high exemption or abatement and to the provisions for collection at the source. The life insurance companies conducted probably the most extensive campaign to modify certain provisions, and with some though not entire success.

Since the law went into effect a short time ago, criticism has broken out anew. Legal proceedings have already been begun to test its constitutionality; many bankers and holders of interest coupons have complained of its inconvenient and vexatious requirements; and the press of the whole country has been flooded with statements of lawyers, bankers, and others to the effect that the provisions of the law are intricate, inconsistent, and incomprehensible. Apparently there has been a concerted movement to force upon the whole country the impression that these characterizations of the tax are true.

As a matter of fact, there is a considerable amount both of truth and of untruth in these assertions. The income tax law as enacted is comparatively brief and for the most part is merely a framework of general principles upon which to build up the details of the structure. These main principles are fairly simple and easy to comprehend. But the act provides that the details shall be worked out by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury. Inasmuch as the law is still very new, comparatively little of the structure has been erected and fixed in final form as yet, but new rulings are being issued rapidly, and in due time points not definitely and specifically covered by the act should be intelligible and clear to all concerned. It is not reasonable to expect that a new system of the proportions contemplated by the law can be established all at once without some inconvenience and some difficulties of interpretation. Income taxes in other countries have usually provoked widespread and continued opposition at first and have later been accepted as among the most satisfactory of taxes.

The new tax has been modeled partly upon those of 1894 and the Civil War period, partly upon the recent corporation tax, and also to some extent upon the English income tax. Its adoption to meet the deficit expected from the lower tariff rates is somewhat

analogous to England's adoption of her income tax in 1842 in connection with the repeal of the corn laws. The demand of the English manufacturers for cheaper food for their employees was not without some counterpart here, and it is probable that this demand, together with the demand for cheaper raw materials, will operate with even greater force to reduce tariffs in the future.

In accepting the principle of progression, the new law departs from that of 1894 and follows the principle of the English supertax which was successfully resisted in that country for many years but finally adopted in 1910. It does not follow the English principle of differentiation between earned and unearned incomes, a reform approved there in 1907, nor does it divide incomes into schedules as does the English law. But in the fundamental administrative matters of assessment and collection of the "normal tax," it does follow the English principle of stoppage-at-the-source rather than the Prussian system of self-assessment of the lump-sum income of each individual.

Further discussion of the new tax will be clearer after an analysis of the provisions of the law. The constitutional amendment making the law possible is as follows: "Congress shall have power to lay and collect taxes on income from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

Chief Provisions of the New Law

Except as otherwise provided, the new income tax is to be levied "annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States, whether residing at home or abroad" and to every resident alien. A like tax is to be levied upon the "income from all property owned and of every business, trade, or profession carried on in the United States by persons residing elsewhere."

The term "income" includes such gains and profits as wages, salaries, interest, income from trade, business, professions, sales, and transactions of every kind, but it does not include proceeds from life insurance policies nor the value of property acquired by inheritance or gift. The inclusion of the word "accruing" makes the tax payable for the year in question, even though the income may not be actually received until later.

The income tax is really composed of three fairly separate and distinct taxes: first, and simplest, a "normal tax" of one per cent

upon the entire annual net income of every corporation; second, a "normal tax" of one per cent upon the excess above $3,000 of every individual's net income ($4,000 deduction allowed married couples); and third, a graduated "additional tax" upon the excess above $20,000 of every individual's net income. That is, corporations are not allowed the $3,000 deduction, but, on the other hand, they are subject to the "normal tax" only, not to the "additional tax," as are individuals. Insurance companies, however organized, joint-stock companies, and associations are treated as corporations. The incomes of partnerships are to be returned and taxed as parts of the incomes of the individual partners.

The rates of the "additional tax" upon parts of the net income are as follows:

Amount	Per cent
$20,000 - $50,000	1
50,000 - 75,000	2
75,000 - 100,000	3
100,000 - 250,000	4
250,000 - 500,000	5
500,000 - any excess	6

In computing an individual's net income for purposes of both normal and additional taxes, the following deductions are allowed: first, necessary expenses actually paid out in carrying on any business, but not including personal, living, or family expenses; second, interest on indebtedness; third, national, state, and local taxes, but not including those assessed against local benefits; fourth, losses not compensated for by insurance or otherwise; fifth, worthless debts; sixth, depreciation, but not expenses for betterments.

Three other deductions are allowed individuals for purposes of the normal tax, but not for purposes of the additional tax: first, the $3,000 abatement already referred to ($4,000 for married couples); second, corporate dividends and earnings upon which the corporations pay the tax; and third, amounts of income upon which the tax is withheld at the source. It will be pointed out later that the second of these deductions will not always avoid discrimination when applying to this class of incomes; in its practical workings there is more difference between it and the third deduction than appears at first glance.

The deductions allowed corporations are much the same as the first set for individuals but there are exceptions worth noting.

Nothing is said in the law relative to the deduction of a corporation's worthless debts, but a ruling will doubtless permit this. Corporations are prohibited from deducting taxes which they pay upon interest of bonds in pursuance of a previous guarantee that such interest will be tax free to the purchasers, and all future contracts relative to payments of the income tax, whether by corporations or others, are declared invalid. If the interest-bearing obligations of corporations exceed their capital stock in amount, they may deduct only half the interest on such excess indebtedness. This latter provision prevents an evasion of the corporation tax by substituting bonds for stocks and incidentally it discourages excessive bond issues.

Furthermore, corporations are not given the right to deduct the amounts of income derived from other corporations, as are individuals. That is, holding company profits will be subject to double taxation. Insurance companies may deduct net additions to reserves required by law, and any sums other than "dividends" paid upon policy contracts. They are not required to include as income parts of premiums which are paid back or credited as abatements on other premium payments within the year. Here is a conflict as to the term "dividends" which will be noticed later.

Both individuals and corporations are required to take the initiative in filing claims for deductions. The claims of individuals may be filed either with the corporation or other "source" authorized to withhold the tax, or with the internal revenue collector of the district. Corporation claims may be filed with the collector only.

The law allows a number of exemptions, most of which are for the purpose of avoiding constitutional difficulties, though some are partly for administrative and political reasons. It exempts the interest upon all federal, state, and local, but not foreign, government bonds; the compensation of state and local, but not federal, government employees and officers; and the salaries of the present President and federal judges for their present terms. It exempts numerous organizations not operated for the profit of stockholders, as, for example, labor, agricultural, fraternal, religious, charitable, scientific, educational, civic, and similar organizations. In this group are included savings banks not having a capital stock represented by shares and domestic building and loan associations. It exempts also the income derived by a state

or other governmental subdivision from a public utility or from the exercise of any essential governmental function.

The normal tax (one per cent) upon the net income of every corporation is to be paid by the corporation for itself, that is, there is to be no collection of this tax from debtor sources. On the other hand, the normal tax upon incomes of individuals is to be collected at the source so far as seems practicable; that is, a corporation or other "source" of an individual's income, before paying the individual, is to deduct the tax, turn it over to the government, and pay the remainder only to the individual. The term "source" includes not only the original payer of the income, but also any agent who has the payment or control of the income at any of its stages. Of course, arrangements are made to prevent more than one "source" from deducting the same tax.

Though collection of the individual's normal tax at the source is the rule, there are some exceptions probably as important as the rule itself. The tax is not to be withheld at the source if the income is indefinite or irregular as to amount or time of accrual, nor in other cases is it to be thus withheld until the amount due an individual within any one calendar year exceeds $3,000. In these exceptional cases, the income is to be returned or reported personally by the individual for purposes of the normal tax, as well as for the additional tax. There is one important exception to the last-named exception. In the case of interest on corporate obligations, the tax is to be withheld by the corporation or its agent, although such interest does not amount to $3,000. This has particular reference to interest coupons payable to bearer, and will be noticed hereafter.

In addition to the exceptional cases mentioned in the last paragraph, the individual is to return personally, also, all his net income which does not pass through other's hands, as, for example, incomes from business, professions, sales, trade, and other occupations and transactions managed by himself. He is not required, however, to make any personal return whatever, unless the total amount of his net income that would otherwise be subject to personal return exceeds $3,000. If this latter class of income, which neither he nor any one else returns, is less than his allowable deduction, and if he has other income which is taxed at the source, he can secure the full amount of exemption by filing claim for the additional amount to which he is entitled with the withholding "source" or with the collector of internal revenue.

All persons, firms, corporations, guardians, executors, lessees, and others having the control or payment of incomes are not only required to withhold the normal tax as outlined above, but they are also personally liable to the government therefor.

It is to be noted that the preceding paragraphs relative to withholding the tax at the source have reference to the normal tax rather than to the additional tax. It is not intended that the latter should be collected at the source. For the purposes of the additional tax, every individual having a total net income in excess of $20,000 is required to make a personal return of such income. He must include in his return, not only everything he would include for the normal tax, but also the parts of his income from which the normal tax is withheld at the source. Furthermore, he must include both corporation dividends which he actually received and also the proportion of undivided corporation profits to which he would be entitled if the same were divided and distributed. It is obvious that the additional tax could not be withheld at the source, inasmuch as it is graduated according to the total income of the individual, for no one of his debtors or "sources" would know the aggregate of his various incomes and hence would not know the rate applicable.

Every person or concern collecting the incomes which arise from the foreign investments of Americans is required to obtain a license from the Commissioner of Internal Revenue and is subject to his regulation. No charge is made for the license but bond may be required. This is in pursuance of an English practice which has proved very advantageous in the intercepting of incomes that formerly escaped. It will be relatively less important here on account of fewer American investments abroad.

Upon special request, the collector of internal revenue may require returns of incomes which do not exceed $3,000 and he may make almost any other reasonable requirement for information from individuals or corporations relative to their own incomes or those of others. The federal district courts may compel the production of books and the giving of testimony; and, upon due notice to the person concerned, the collector may revise returns which he believes to be incorrect. Rather severe penalties are provided and any omission or fraud discovered within three years may be corrected. Aggrieved persons may appeal to the Commissioner of Internal Revenue.

For the purpose of putting the law into effect, $800,000 is

appropriated for the fiscal year ending June 30, 1914. The act authorizes the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, to appoint and pay from this appropriation all necessary officers and employees and to provide for all other necessary means of carrying out the law. No agent paid from the appropriation is to receive a higher rate than that now received by travelling agents of the Internal Revenue service, and no inspector is to receive more than $5 per day and $3 additional in lieu of subsistence. Subordinate employees may not be paid at a higher rate than that now paid for similar service in the Internal Revenue service. For the central office in Washington, the law provides for the appointment of one additional deputy commissioner with a salary of $4,000 and two heads of subdivisions whose compensation shall not exceed $2,500 each. Appointments, except for clerical force below the grades of chiefs of divisions, are removed from the civil service requirement for a period of two years. The force of officials, when not employed in carrying out the provisions of the income tax law, are to be employed on general internal revenue work.

Criticisms

So far as the general principle of an income tax is concerned, argument is scarcely necessary today to convince either economists or the public that family income is a more equitable measure of taxation than is family consumption of the usual tariff-taxed commodities. Though there is less unanimity regarding progression, nevertheless, the tendency in all countries and among both the theorists and the masses is strongly in the direction of graduated or progressive taxation, and the present income tax is distinctly in harmony with this tendency.

It is true that a proportional, or flat-rate, income tax would be much easier to administer and would cause much less evasion and fraud than a highly progressive tax, and for this reason, some authorities pronounce the progressive feature impractical, though more equitable in theory. It is very probable that the gain in administration in the beginning would have more than justified the imposition of only the normal tax or some similar tax. After administration had been perfected, the addition of a super-tax would then have caused much less difficulty and evasion than will occur under the present law. But the masses are not versed in the administration of taxes, and public opinion would not have accepted

a law so contrary to popular ideas of justice; hence, we have begun with progression, a principle which England refused to accept for seventy years for fear it would demoralize administration.

As to what the rate of progression should be there is little agreement of opinion. No satisfactory theory which is capable of practical application has as yet been evolved. In the practice of most countries, the first steps in this direction are usually conservative, and rates are generally called confiscatory, or discouraging to productivity, probably much before they actually reach such stages. The rates of progression in the present income tax are thus conservative when we consider the size of the deductions both for the normal and for the additional taxes.

It is to be noted that the higher rates do not apply to the entire income, but only to the excesses above the given steps for the respective rates. Thus an individual with a net income of $700,000 will have to pay the additional tax of six per cent not upon $700,000 but upon only the $200,000 in excess of the last step of $500,000, and he will have to pay five per cent upon only the amount between the $500,000 and the next lower step of $250,000, and so on throughout.

In discussing the rate many seem to overlook the great difference between an income tax and a property tax expressed as the same percentage. For example, a one per cent property tax on five per cent bonds amounting to $100,000 would be $1,000, whereas a one per cent income tax would be only $50, assuming that there are no exemptions in either case. Under the liberal deductions and exemptions of the present law, however, the income tax will be even less. It is almost insignificant or non-applicable so far as the great majority of incomes are concerned. For example, a married man with a net income of $5,000 will be required to pay an income tax of only $10; incomes of $20,000 will pay only $160; those of $500,000 will pay $25,020, or only five per cent. The latter is the equivalent of a property tax of 50 cents on $100, if investments yield five per cent. These net rates are lower than are the rates for the corresponding amounts in most countries, as, for example, in England, Prussia, Austria, and Italy.

It is impossible to consider net rates without considering deductions and exemptions. Perhaps no feature of the present law or of the 1894 law has been more severely criticised than the high deduction or abatement of $3,000 allowed each individual ($4,000

for married couples. The abatement in the law of 1894 was $4,000). In the United States the same abatement is allowed on all incomes regardless of their amounts. In England the amount of the abatement decreases as the amount of the income increases. There the largest abatement allowed is £160 ($800) and that only in case the income does not exceed £400 ($2,000). Incomes totalling between £400 and £500 are allowed an abatement of £150; those between £500 and £600, an abatement of £120; and those between £600 and £700, an abatement of £70; but incomes in excess of £700 are allowed no abatement. However, additional allowances are made for life insurance, charity, and hospital expenses, and if a man's income is under £500, he is allowed an additional abatement of £10 for each child under sixteen years.

In Prussia, 900 marks ($214) is exempt, and if a person is assessed for a taxable income of not over 3,000 marks ($714) he is allowed a deduction of 50 marks ($12) for each child under fourteen, or for each relative that he is legally bound to support. In case the income is between 3,000 and 6,500 marks, there is a reduction of one grade if three or four children or relatives have to be supported, and a reduction of two grades if the number is five or more. In Austria the regular abatement is 1,200 crowns ($240); in Italy, 400 lire ($77.20); in New Zealand, £300 ($1,500); in New South Wales, £200 ($1,000); and in Queensland, £200 if the income is entirely from personal exertion. Most of these countries allow some additional abatements, for example, for life insurance, children, or other causes of expense which it is thought should not be discouraged.

As compared with other countries, then, it is evident that our $3,000 abatement is high. It is most frequently criticised as being so high as to make the tax, in effect, a class tax upon the rich, which can be voted by the poor, and a sectional tax upon the East and Northeast, which is voted by the West and Southwest. There is much truth in these criticisms; and a survey of the states and congressmen ranged on the different sides of the amendment and of the new law confirms this statement.

But, notwithstanding this fact, something may be said in justification of the abatement, high as it is. The standard of living is higher in the United States than in most countries; and it is to be noted that abatements elsewhere are highest where the standard of living is highest, namely, in the English colonies. As compared with previous United States income taxes, the differences in

abatements are not so great as they appear; $3,000 has no more purchasing power today than $2,000 had in 1894. The same is true of the Civil War taxes, and these, it should be noted, were emergency measures.

In any consideration of the new income tax, it should be kept in mind that it is a supplementary and not an exclusive source of revenue. According to the Treasury estimates it will not produce half as much as the lowered tariff rates, to say nothing of other taxes. The new tariff schedule, though less objectionable than the former one, may still be considered a class tax which discriminates against consumers, that is, against those with small incomes; hence equity calls for an offsetting class tax upon the rich. There is some truth in the objection that the masses will take little interest in governmental extravagance because they pay none of the new tax, but the same objection applies with almost equal strength to the tariff so far as any practical effects are concerned. Although state and local taxes are paid largely by the middle classes, expenditure seems to be accompanied by about as much extravagance and graft as in the case of federal finances. There are numerous exceptions, particularly in the smaller local units, but in neither case does the individual taxpayer as such have sufficient interest to cause or justify the inconvenience and expense of an effective protest.

If the tax hits the East and particularly New York City especially hard, it is because these are the localities of the large incomes; and they will be able to pay in proportion. Many receivers of large incomes, in fact, the most conspicuous ones, did not live in New York City originally, but moved there because of its advantages as a commercial and financial center, or as a place to spend large incomes. Not only has much of the wealth of this American metropolis been accumulated elsewhere, but a large share of it still comes directly or indirectly from other parts of the country. The same is true of other large centers. These incomes arise from oil, sugar, steel, railroads, and a thousand different forms of wealth which minister to the wants of our 100,000,000 people and which at the same time levy tribute and keep it pouring into the great centers, and particularly into the coffers of the nation's captains of industry.

Such incomes are not local but national in the highest degree and should therefore most appropriately be assessed for national taxes. These centers and their wealthy residents have cause for

satisfaction and thanksgiving that their incomes are so bountiful, and that the country has provided them with such great opportunities, rather than occasion for criticising the requirement of a moderate contribution to the nation which has rendered such incomes possible. To collect taxes on these incomes by apportionment, whether according to population or area, would be manifestly unjust, and it was because of this injustice that the constitutional amendment was necessary.

Without doubt, the desire to level incomes, and the willingness of politicians to cater to the prejudices of the masses have had some part in the demand for the income tax. The movement is a part of the great unrest of the present generation which will produce many radical changes before it has spent itself. But past experience indicates that, though radical in their entirety, they will be brought about very gradually. Formerly the income tax was objected to, no doubt, as being an entering wedge rather than because of its immediate effects. Today opposition to the principle receives little support from any source. If the time shall ever arrive when this tax is the chief or exclusive source of revenue, to make it a class tax upon the rich, which can be increased or decreased at the will of those who do not pay it but who receive the benefits of its expenditure, will be as unjust as the making of any other tax a class tax for the benefit of other classes. But it is doubtful if it would be more unjust, in such a case, than have been tariffs and other taxes from time immemorial.

Another important consideration is the matter of administration. The new law provides for the same abatement upon all individual incomes with only one exception, that is, in case of married couples an additional deduction of $1,000 is permitted. These abatements are high enough so that they may be considered to include the numerous small abatements which other countries allow for children, insurance premiums, hospital expenses, etc. Many varying abatements add much to the complexity of administration.

Furthermore, high abatement, which permits the escape of such a large proportion of the incomes, at the same time permits the avoidance of the assessment of those incomes which involve the most expense in proportion to the revenue obtained. To reach the smallest incomes, indirect taxes are more practicable. A substantial lowering of the abatement would not increase revenue receipts as fast as it would multiply difficulties of assessment and collection.

But most important of all, we have not yet developed adequate assessment machinery. As we collect a mass of data and as we train a corps of expert administrators, the abatement may be lowered and more incomes included, but to do so in the beginning would clog the machinery. The same principle is applicable to the rate. A very high rate will cause much more evasion and often produce less revenue than a low one. Later, after the collection of data and the training of administrators, such evasion, even under higher rates, becomes less probable and possible. From this standpoint, the additional tax rates may be considered rather high to start with, but inasmuch as most incomes liable to this tax will arise from corporate or other sources which are difficult to conceal, this objection will be relatively unimportant.

For reasons such as these it is important to view the new income tax, not as an ideal or perfected system, but as the first step in the introduction of a vast and more or less complex system. As administrative machinery is developed and as it becomes desirable to reduce tariffs still further, it will become more feasible to lower the abatements, to extend and differentiate the applications, and to make the tax a more comprehensive, a more remunerative, and a more equitable revenue producer.

The exemption of interest from United States bonds is in accordance with uniform past policy and consequently tends to uphold and strengthen the present high credit of the national government. To many of the ill-informed who do not understand the capitalization of a tax, such exemption will seem a species of class favoritism; and to avoid this class feeling there is some justification for taxing such incomes. In the long run, it makes little difference to a government whether it taxes its bonds or not, provided it always follows the same practice. The modern tendency is toward taxing them rather than toward exemption as in the past.

The exemption of interest from the bonds of the states and minor subdivisions, and also of the compensation of officers and employees of these local governments was made for constitutional reasons, as well as for the sake of comity and political expediency. A line of court decisions from John Marshall down has set up the doctrine that no state has the right to tax the instrumentalities of the federal government, because the power to tax is the power to destroy, and, conversely, that the federal government has not the right to tax the instrumentalities of the state governments. It may require a new decision of the Supreme Court to determine

whether or not the sixteenth amendment set aside the application of this doctrine in part, though Professor Seligman has made out a very strong case for its continued applicability.[2] In this connection it is interesting to note that the institution of the tax apparently, and probably actually, caused an increase in the price of the exempt bonds in November during which month the first collections at the source began. Such a change is in harmony with the theory of capitalization. The justification of the discrimination in favor of the receivers of these various forms of exempted incomes must stand upon political and legal rather than upon economic grounds.

The exemption of the capital value of inheritances from the income tax is a recognition of their taxation by the states and as such tends to promote harmony in the separation of the sources of federal and state revenues.

Of the deductions allowed for expenses in the computing of net incomes, those for losses, depreciation, and worthless debts will doubtless cause much trouble and necessitate many rulings on the part of the Commissioner of Internal Revenue. Though the law says that personal, living, and family expenses shall not be allowable deductions, it leaves open the old and important matter of rental value of residence property. It should have stated definitely that such rental values were to be returned as taxable income; otherwise a renter of a home will be discriminated against and the owner-occupier favored. The owner-occupier of a Fifth Avenue mansion whose rental value is $100,000 would pay no tax on such enjoyable value, while the renter of a similar mansion, or of a tenement, if he has income enough to bring him within the pale of taxation, would pay a tax on what he paid for rent. The ruling that will have to be made on this point may or may not decide it correctly. An improper ruling would probably cause less protest than a proper one.

The provision allowing an individual to deduct corporate dividends from returns for purposes of the normal tax does not prevent the tax from being a discrimination against that particular form of income in case the individual does not have other net income equal to the amount of the $3,000 (or $4,000) abatement. It is true that he does not have to pay the normal tax upon this corporate dividend again (it has been paid once by the corporation);

[2] *Political Science Quarterly*, vol. XXV (June, 1910), p. 193.

but the normal tax would not have been paid even once upon any other form of income if his total income had not exceeded the amount of the abatement. That is, corporate dividends are discriminated against. This may be considered a special corporation tax in addition to the regular income tax.

Somewhat related to this is the fact that, under the new law, holding company dividends will be taxed twice, first as the dividend of the subsidiary company, and second as the dividend of the holding company. According to a decision under the recent corporation excise tax law, mere holding companies were not taxable because they were not engaged in business.[3] Under the present income tax law, their receiving or being entitled to income or undivided profits, is the test of whether or not they are taxable, and not their being engaged in business. In the words of the new statute: "the fact that any such corporation, joint-stock company, or association is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of fraudulent purpose to escape such tax." The Secretary of the Treasury is designated as the one to construe the term "reasonable."

The exemption of insurance "dividends" about which the insurance companies made such a stir while the bill was pending, was left in an ambiguous condition in the law. The ambiguity arises from the double meaning of the word "dividend." It might be said its origin is due to the intentionally misleading use made of the term by the companies in their attempts to write insurance. An insurance "dividend" is not the usual profit made upon ordinary corporate stock, but the return of an overcharge caused by too great a premium payment. In so far as expenses of insurance are reduced by the interest received upon premiums, and in so far as this return of overcharge represents such earnings, it may be considered a dividend in the usual sense of the word. But insurance "dividends" are usually taken from a fund in which have been mingled moneys from several sources: interest upon premiums or reserves, savings from loading, and savings from lower than the calculated mortality. Or it may be considered that all of this fund arises from overcharges.

The law expressly excludes "dividends" from the deductions permitted insurance companies, but says that rebates on premiums,

[3] United States Supreme Court decision in the case of *McCoach* v. *Minehill and Schuylkill Haven R. R. Co.* (228 U. S. 295).

whether returned to the policy holder or retained by the company and treated as abatements of premiums, may be deducted from gross income in computing the taxable net income of the company. This latter permitted deduction is the result of a Senate amendment. It will probably result in a slightly different system of insurance accounting which will provide for the keeping of the different kinds of savings in separate funds instead of merging them in one. The interpretation of the term "insurance dividend" under the corporation tax law is now in the courts. Under that law, the ruling of the commissioner allowed no deductions for such dividends nor for rebates in lieu thereof.

Increase in property values is another matter that will doubtless give considerable difficulty. This kind of income can be handled more easily when it accrues to corporations or firms with proper accounting systems than when it goes to proprietors without such systems. Under the rulings for the administration of the corporation tax, profits on real estate and other physical assets, whether sold or not, were treated as income when such gains were taken cognizance of by the corporation's book entries. If it were possible to prescribe standard forms of accounting for all corporations as successfully as has been done by the Interstate Commerce Commission with reference to the railroads, very little difficulty might be encountered from this source, as far as corporations are concerned.

But in other cases, if such profits are to be treated as income, as they should be from an economic standpoint, the difficulties of administration will often be very great. In fact, only approximations will be possible in many cases, for it will necessitate not only the assessment of what are usually known as incomes, but also the periodical assessment of property values as well. It is doubtful if such a task will be undertaken, especially in the beginning.

The application of the tax to all non-resident citizens, to resident aliens, and to incomes from property, business and professions carried on in this country by persons residing elsewhere, is inconsistent and will result in some unjust double taxation besides considerable evasion which will be more or less justifiable and also in an unfortunate lack of international comity. In this matter, however, the United States is merely following the bad examples set by other countries. This is analogous to the lack of interstate comity within the United States, the difficulty in overcoming which has been one of the most serious drawbacks to domestic tax reform.

But, inasmuch as international relations are not so close or extensive as domestic ones, the difficulty will not be so serious in its effects as that caused by the lack of interstate comity.

It may be stated in this connection that the Commissioner of Internal Revenue has ruled that non-resident aliens who own bonds of American corporations may claim exemption from the tax upon the interest coupons of such bonds by filing certificates of ownership. However, foreign correspondents have already pointed out[4] how this will aid foreign tax dodgers in so far as this class of income is reinvested here. If this can finally be returned to the foreign country as principal or capital rather than as interest or income, it may escape entirely; but if not so treated, and if it is intercepted upon its return, the payment of the tax will merely be delayed. Nevertheless, this ruling does open up a possible way of evasion to both American and foreign investors through a process of clearing or exchange of securities. It has been pointed out also that the swearing off of the American tax may mean the swearing on of a European tax which the coupon holder has been able to evade to date by maintaining secrecy as to his ownership. In such cases, owners will probably choose the lesser evil.

The adoption of the stoppage-at-the-source system of collection is in harmony with the best experience in income tax administration both here and elsewhere. This is more practicable in the United States than in countries where the corporate form of organization is less extensive. The tax will probably be least successful, as has been true elsewhere, in its application to business and professional incomes upon which it cannot be collected at the source. Self-assessment always puts a premium upon evasion which the great majority never resist.

Even as the new law stands it provides for too little collection at the source and too much self-assessing. Collection at the source and graduation of rate are not in harmony with each other; hence for the additional tax, self-assessment is more or less inevitable. But inasmuch as most incomes subject to the higher rates will probably come from corporate sources, it will be possible to check the correctness of such returns to a considerable extent. But it will be impossible for individuals to include in their returns, for purposes of the additional tax as they are supposed to do, their shares of undivided corporate profits unless the corporations

[4] See London correspondence of the *New York Times Annalist,* Nov. 24, 1913, p. 665; and Paris correspondence, Dec. 1, 1913, p. 685.

furnish their stockholders with such information. This requirement will be still further complicated in case such profits arise from corporations that choose to make their returns for their fiscal years rather than for calendar years for which the individual is required to make his return.

But for the normal tax, also, many classes of incomes will be self-assessed. All parts of incomes derived from corporations or other sources, where the amount from each source falls below $3,000, will be reached only by self-assessment, with the single exception of interest on corporate bonds. The same is true of the incomes in excess of $3,000 that are not fixed, regular, and certain as to amount or time of accrual. Professional and business incomes will constitute a large portion of this class. Thus persons with large aggregate incomes arising in small or moderate amounts from several different sources, or with incomes which are irregular, or with incomes from business or professions which are under their own direction, will have much opportunity for evasion not only through failure to make complete returns, but also through improper claims for deductions. It will require very careful, industrious, and expert administration to see that such evasions are prevented from the beginning and not allowed to grow and destroy the efficiency of the entire system.

The high abatement will relieve most farmers from making returns, but if it were lowered to what it may be in the future, the assessment of their incomes under the present law would be very difficult and unsatisfactory because of the inadequacy of farming accounts. In such an event, it would be better to assess land upon its rental value, which is a sort of average income, as is the practice in England, than upon the income of each particular year. This objection holds for agricultural incomes which exceed the abatement of the present tax, though it is probable that the receivers of such large incomes have better systems of accounting than do most small farmers.

Up to the present time, perhaps no administrative feature of the new law has caused more inconvenience and consequent criticism than the requirement that interest coupons payable to bearer, when presented for collection, shall be accompanied by attached certificates of ownership with or without claim for exemption. Banks could have cashed these coupons at once as formerly with entire safety to themselves by withholding the normal tax, forwarding it to the collector of internal revenue, and paying the

difference to the presenter of the coupons. But this would have involved considerable clerical work and a later refunding of the tax in cases where the presenters fell within the limits of the abatement; hence, the banks did not see fit to cash the coupons upon presentment.

It is clear, however, that some such statement of ownership to accompany such coupons is necessary if the tax is to be effective and if the abatement is to be granted as contemplated by the law. Otherwise a receiver of $100,000 interest in such form could have his coupons presented by forty of his friends in lots of $2,500 each and evade the tax. The law might have prevented the inconvenience by providing for no abatement on such incomes or by providing that corporations should pay the tax upon them, but such provisions would have been discriminatory and probably would have caused as much protest as the present inconvenience. If the threatened effort to secure a change in the law should be successful, permitting personal returns of taxes upon such incomes to be substituted for collection at the source, it would turn the law into a farce. If, on the other hand, the present system is continued, it is probable that there will be some changes in business methods to reduce inconveniences. Either interest coupons payable to bearer will be replaced by registered coupons to some extent, or more convenient methods of collecting and accounting will be adopted. Friction and inconvenience should be reduced to a minimum as business and people generally become more familiar with the requirements of the law and as the rulings of the Commissioner of Internal Revenue assist in its adjustment to business requirements.[5]

In England, the income tax is used to adjust the revenues to the needs of the government. For this purpose the rate can be changed from year to year. This cannot be done with tariff rates without seriously disturbing business. A country which depends mostly on customs for revenues alternates between periods of deficits and periods of surpluses, both of which bring serious evils. The United States will not be in a position to make advantageous use of this balancing feature until it adopts proper budgetary control of receipts and expenditures.

An additional feature to commend an income tax is its value in case of emergencies. When a nation engages in a great foreign

[5] Since this paragraph was first written, several rulings on this point have been issued by the commissioner.

war, its customs receipts usually fall very low just at the time when it most needs increased revenue. Then internal taxes are resorted to. The United States bankrupted itself in the War of 1812 and suffered all the calamities of the greenbacks in the Civil War for lack of an established internal revenue system. On such extraordinary occasions few taxes could be used to better advantage than an income tax. But the emergency value of this tax lends no support to the frequent protest that it should be retained for emergencies only, or even chiefly. If it is more equitable than a tariff or other taxes, that very equitableness is the strongest argument for its being the source of the ordinary annual revenues. Justice as a rule and injustice occasionally is better than the reverse.

The removal of the chief appointments from the civil service gives the Commissioner of Internal Revenue a freer hand and a better opportunity to secure an efficient, sympathetic, and responsive staff of administrators, if he is equal to the task and is not hindered by the demands of congressional patronage. At the same time, it opens wide the door to possible abuse. The law's limitation of compensation to be paid indicates that Congress has not a real appreciation of the administrative requirements of such a tax. Even with a large corps of the best men available, it would be a very great undertaking to establish the new tax throughout the United States so as to reach a maximum of efficiency.

It is unfortunate that we have no local officials corresponding to the land tax commissioners of England with whom the collectors of the federal tax can coöperate, as is done there so successfully. However, it is possible that some such coöperation can be devised by a resourceful administration. At least, such assistance might be secured by coöperation with local assessors and others in points of vantage, although this would be only one step in the right direction. It is also unfortunate that we do not have a body of trained collectors similar to the inspectors and surveyors of England, but such a corps could be secured in the course of time if we had the same traditions relative to expert service, tenure of office, and promotions. It is to be hoped that we may develop this in time, also.

In the state of Wisconsin, which has a state income tax with a much lower abatement than the national tax and which has also an excellent administrative system, the work of the federal income

tax collectors should be immeasurably more efficient than elsewhere. If Wisconsin's income tax proves to be as successful permanently as it seems to have been so far, doubtless other states will adopt similar systems and the efficiency of the federal tax be thus extended.

In conclusion it may be said that the fundamental principles of the new law are sound and that its details, so far as worked out, are sufficiently correct to insure its success if it is properly administered. Popular opinion is closely enough in harmony with it to overlook much unfriendly criticism and to help assure its success. Though it seems probable that it will not be administered nearly so efficiently as it might be, still it can hardly fail to be very effective as applying to incomes reached at the source. As time goes on it will doubtless be differentiated and extended and will become a great fiscal engine. As in the case of most taxes, efficient administration is the great desideratum. Because of the extraordinarily great powers that have been given the Commissioner of Internal Revenue and the Secretary of the Treasury, it may fairly be said that the responsibility for the success or failure of the new tax is upon their heads.

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